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Federal Open Market Committee

Conference Call

April 29, 1987

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Boykin
Mr. Heller
Mr. Johnson
Mr. Keehn
Ms. Seger

Messrs. Black, and Forrestal, Alternate Members
of the Federal Open Market Committee

Messrs. Guffey, Melzer, and Morris, President of
the Federal Reserve Banks of Kansas City,
St. Louis, and Boston, respectively

Mr. Kohn, Secretary and Staff Adviser
Mr. Bernard, Assistant Secretary
Ms. Loney, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Truman, Economist (International)

Mr. Prell, Associate Economist

Mr. Sternlight, Manager for Domestic Operations,
System Open Market Account
Mr. Cross, Manager for Foreign Operations,
System Open Market Account

Mr. Coyne, Assistant to the Board of Governors

Messrs. Hendricks, Powell, and Stone, First Vice
Presidents, Federal Reserve Banks of
Cleveland, San Francisco, and Philadelphia,
respectively

Transcript of Federal Open Market Committee Conference Call
of April 29, 1987

MR. BERNARD. [Roll call of Reserve Banks expected to participate in the conference call.] Thank you. All of the Reserve Banks are on, Mr. Chairman.

CHAIRMAN VOLCKER. Well, gentlemen and lady here--we only have one lady on the Committee, now.

MS. SEGER. [Our number is] reduced by 50 percent.

CHAIRMAN VOLCKER. Obviously, there has been quite a lot of turmoil going on in markets recently, whatever market one looks at. We have had problems with open market operations. We have a number of policy issues, and I thought it was appropriate just to review where we are. I think it's fair to say that pretty much since the last Open Market Committee meeting, pressures have developed on the dollar. That occurred not long after that meeting. And in accordance with the discussion at that meeting, we were playing things rather cautiously but not really changing the borrowing target in any overt or non-overt way. We had our usual problems in sometimes meeting and sometimes missing targets; there was no change in the target but there was erring on the side of restraint--if that's the right word--in making any day-to-day judgments that may have been appropriate.

In accordance with the discussion and given what was going on in the market, [our approach] changed a bit this week. We assumed that under these circumstances we would aim overtly at a somewhat higher target, something around \$400 million. I think the market has that sense now--not about a number but a feeling that we probably have deliberately snugged, if that's the right word, this week. Now, in fact, we have many fewer reserves out there than we intended because of technical problems, which I'll let Mr. Sternlight and Mr. Kohn discuss with you. But what has happened, essentially, is that we were willing to aim slightly higher, and then all the reserve factors came in strongly adverse both yesterday and today. We don't know whether that will continue to be the result. We put in a lot of money both yesterday and today--as much money as the market would take--but we still have a little hole for ourselves just in terms of strict targeting. Given the direction in which we're going, I'm not sure that that's any disaster from the standpoint of the market. You will have observed that both the exchange market and the bond market--and I think those two phenomena are not unrelated--have considerably strengthened over the past couple of days, although they have had some intermeeting ups and downs. Just as a matter of general background, the Board is going to have to keep the question of the appropriateness of a discount rate move under consideration. All of this is somewhat dependent, at least ideally, on what goes on abroad. There is at least some verbal indication that the Japanese would like to see rates ease a little in Tokyo markets. They have a sharply declining bond market rate; that's just the opposite of what's been going on here. It's a reflection both of expectational factors and actual shifts of purchases out of U.S. bonds into Japanese bonds by Japanese investors, without necessarily at all connoting a change in monetary policy. But they have told us that they would aim toward lower money market rates. In fact, I was told this morning that they said that publicly in some

kind of press contact that the Governor has. It didn't receive much attention here; I haven't seen it anyway.

MR. JOHNSON. They didn't say it very loudly.

CHAIRMAN VOLCKER. I don't think it was said. It's very strange; the Japanese press generally picks it up and reverberates it. They told me they said something publicly and I'm trying to get more details on that. The only other thing I would add is that I have to testify tomorrow morning, not on monetary policy but on risk-based capital. I'm sure this question [of current policy] will arise. And I would think that I should confirm that we have had a small snugging or tightening, or whatever word seems appropriate at the time, in the light of the circumstances in the market. I certainly would not try to get that out of perspective; I'd try to avoid further trouble. That's about where we are at the moment. Oh! I might just indicate, and the staff can describe it more fully, that while all this has been going on--and it's one of the reasons the reserve factors are moving so strongly against us--the money supply, or M1 at least, has ballooned very sharply over the middle of the month, presumably related to larger-than-expected tax payments. But it hasn't washed out yet. Peter, why don't you describe it?

MR. STERNLIGHT. I think both things that have happened on the reserve supply could be well be related to the tax situation, particularly the individual taxes that have been coming in very heavily right about April 15th. And since it takes a while to process those, particularly the individual payments, we've been getting much, much higher Treasury balances than had been expected. At the same time, I think individuals must have built up their transaction accounts to be able to make those payments. So, we've got a very large indicated increase in the April 20th week. And we're just finding out in the last day or two that where a sharp rundown had been assumed in the following week, we're not getting much indication of that rundown. So, it's giving us much higher required reserves. In just the last three days we've had to move up the path based on required reserves by something like \$1-1/4 billion. At that same time, our estimates day-to-day of the Treasury's balances at the Federal Reserve rose because those balances pretty much filled up the capacity at the tax and loan accounts at the commercial banks. The estimated balances at the Federal Reserve have risen by several billion dollars. We are trying very hard to fill that reserve need while at the same time keeping in mind the desirability of not losing a little of the advantage we got a few days ago in the market by deliberately hanging back in what we thought then were fairly moderate reserve needs. With all of that, borrowing thus far in this period is not badly out of line; it's averaging just a little over \$400 million right now for this current reserve period. The funds rate is averaging something like 6.44 percent, although over the last couple of days it has been more in the 6-5/8 to 6-3/4 percent area. But, as the Chairman said, in the last couple of days the market has gotten a sense--it's not 100 percent sure--that there has been some snugging or deliberate lessening on the Desk's part of its generosity in providing reserves.

CHAIRMAN VOLCKER. Mr. Kohn, do you want to say anything about anything?

MR. KOHN. Well, I can fill in a little on the money supply, Mr. Chairman. As Mr. Sternlight suggested, we expect to publish a very large increase tomorrow afternoon--on the order of \$15 billion--an increase widely expected by the market, which has seen these deposit inflows. And we're not getting the kind of runoff in the following week that we expected. As a result, with an expectation of a decline in the week after that--that is, the first week in May--we still are projecting M1 growth in April in the high teens. Apparently, a good portion of the funds shifted to demand deposits and OCDs seems to have come from M2 components so that the non-M1 part of M2 has been weaker than we expected. So, M2 and M3 may be coming out in the 5-1/2 to 6 percent area, which isn't far from what the Committee's expectations were at the time of the FOMC meeting. Now, how much of that has been artificially inflated by the tax effect, we won't know for a couple of weeks, until that comes out.

CHAIRMAN VOLCKER. Mr. Cross may want to bring us up-to-date or give us a little flavor of what has been going on in the exchange markets in recent days.

MR. CROSS. There has been more or less continuous--. Hello. Do you hear me?

CHAIRMAN VOLCKER. Yes.

MR. CROSS. Okay. If you hear me, I'll proceed. There has been more or less continuous pressure in the exchange markets since your last meeting at the end of March. At times the pressure has been quite heavy. The reasons seem to be more of the same things that we've all heard and talked about, including: discussions of what almost seems like a trade war between us and the Japanese--which gets a lot of attention in the markets and the newspapers; continuing bad figures on the trade deficit; and a lack of any very impressive policy move by the main players. The [unintelligible] did break through some very important psychological numbers. Whereas earlier the pressure had been very heavily between the yen and the dollar, toward the end of last week it began to be more generalized and there were also pressures against the mark. There have been substantial amounts of intervention during this period totaling over during the month of April, of which the very heavy portion has been by the Japanese. There is a recognition by the market that there have been such heavy amounts of intervention. And there is some feeling by the market that this has not been enough to deal with the situation in any lasting way. In addition to the heavy amounts of intervention, there have been substantial other purchases of dollars by the central banks. For the ones that we're on the concertation arrangement with, and that we keep figures for, the total of the intervention and the other purchases has been more than \$20 billion of purchases officially during the month of April. That is quite a substantial amount, well above the rate that we were running in the first quarter. The market has been calmer in the past few days, partly I think in recognition of--or a feeling that there has been--some modest change in the monetary policy approach. Another factor is that Mr. Nakasone is here, and although the market is quite cynical about what may come out of that, they're reluctant to be 100 percent cynical and to be certain that nothing will happen. So there's a kind of wait-and-see attitude. Also, the fact that we have a number of holidays both in Europe and in Japan over the next several days up until the middle of next week I

think has made the traders a little cautious. They say they will come back and look at the situation after the Nakasone visit and in light of what appears to be monetary policy [unintelligible]. That's all I have to say, Mr. Chairman.

CHAIRMAN VOLCKER. Well, as I suggested earlier, it's quite a turbulent period. I think what's been going on in terms of open market operations is pretty much what the directive would have suggested during this period. I don't think we have to do anything formal as a Committee, but I certainly would want to hear any comments or deal with any questions or any observations that any of you have.

MS. SEGER. Maybe I missed it, but what is the borrowing target we're now using? I know we talked about \$300 million at the last meeting but it has been above that.

MR. STERNLIGHT. We had been using \$300 million up to this point, but I'd say in the last day or two we've really been behaving more as though it was a shade higher. And my understanding is that we're prepared to use something a little higher now--I assume \$400 million.

CHAIRMAN VOLCKER. I think \$400 million, notionally, would be the target at the moment.

MR. KEEHN. Peter, this is Si Keehn. At that borrowing level would the federal funds rate tend to ride at about a [unintelligible] level or higher for some reason?

MR. STERNLIGHT. I think there is such a mixture of expectations out there that it's very hard to sort all of this out. Just taken by itself--if there weren't that expectational element of something possibly lurking on the discount rate--we might be having a funds rate of 6-1/4 to 6-1/2 percent or something like that, maybe just 6-1/4 percent. As it is, it has been more like 6-1/2 to 6-3/4 percent in recent days. And that's kind of what I would have expected to see ahead, even without a discount rate increase. If that were to happen as well, then I think we'd see the rate somewhat higher--not higher by the full amount of any discount rate increase, because I think something already has been allowed for in the market.

CHAIRMAN VOLCKER. I think the federal funds rate will be more influenced by psychological factors within that band that you're talking about than anything you could measure by a \$100 million change in the borrowing, given this turbulent atmosphere. If that dissipates, the range will be down; if it doesn't, it won't.

MR. JOHNSON. Peter, what's happening in Treasury bills? Bill yields have been fairly stable to down. Well, they did pick up a little, but they really stayed around the fairly low level. And in many cases, bill yields were declining at the same time that bond yields were going up sharply. I assume this has something to do with the Treasury paying down bills.

MR. STERNLIGHT. I think it has a lot to do with that, Governor Johnson. As you say, the Treasury has been paying down bills since early this year. There really just has been a technical shortage of bills at the same time that there has been some extra

demand in the market because of some of those proceeds of foreign exchange intervention, either by those countries who intervened by themselves in the market or, in some cases, executed transactions over our Desk. We have been a bit of a counterbalance to that because some that we normally would have done for System account reserve provision purposes might well have gone in the bill market. We did more than usual in the coupon market; we've been there three times in the last four weeks for a total of something like a little over \$6 billion.

SPEAKER(?). In coupons?

MR. STERNLIGHT. In coupons, yes sir.

MR. JOHNSON. Have they announced the refunding package today?

MR. STERNLIGHT. They'll be announcing their refunding today.

MR. JOHNSON. Have they cut back the long bond or not?

MR. STERNLIGHT. Well, they'll announce it later.

MR. JOHNSON. Okay.

MR. STERNLIGHT. I think the market doesn't really expect much of a change on that score.

MS. SEGER. What did the PSA recommend to them?

MR. STERNLIGHT. Pretty much a carbon copy of what was done in February, notwithstanding the question about whether foreign participation would be there in the same degree as before.

MS. SEGER. What is the increase in the federal funds rate since last October? It's approaching a full percentage point, isn't it?

MR. STERNLIGHT. It must be around 3/4ths to 7/8ths; I don't know. Since last October, you say?

MS. SEGER. Yes. Isn't that when it started picking up?

MR. STERNLIGHT. Yes.

MR. KOHN. It averaged 5.85 last October and it moved up 3/4 of a point or a little more--7/8ths.

MR. GUFFEY. Just a perspective question, Mr. Chairman: If indeed, for whatever reason, the dollar begins to firm or to settle at its current level, would that suggest that we move to or near the \$300 million level?

CHAIRMAN VOLCKER. I think it might at some point, depending on what other things happen. I would suspect if that happened that rates, in the first instance, would kind of move down by themselves for a while. But we would have to look at the other things--the monetary aggregates, the business situation, inflation. One question that I suppose enters into the approach now, as it always does, is the

question of whether we think the inflationary outlook has worsened in these past few months. That seems to be the view in the market, and it's not unrelated to the exchange rate situation because the inflationary expectations are given in part by the exchange rate moves. But I do think there has been some greater pessimism in the market about inflation, which has helped account for the long-term bond market performance, anyway.

MR. HELLER. This is Bob Heller. We have discussed financial markets a lot, and I certainly agree with the summary that we probably needn't do much or shouldn't do much. But I think we also have to keep in mind the real side of the economy. If you look at the last quarterly numbers: business fixed investment is still going down by 12.8 percent; residential structures are down 7 percent; and consumer spending is down 0.4 percent. If you look at the inflation indicators, there isn't much change on the wage front; everything seems to continue to be rather well behaved compared to a year ago-- somewhere between 3 and 4 percent increases and the union side is much better behaved. If you look at commodity prices, they're essentially going sideways with the exception of oil and the precious metals; certainly, the experimental index is moving sideways. And the aggregates, I guess, are continuing to come in at the bottom of their ranges--there not being a range for M1, which might show a big boost. My view is actually very strongly that Germany and Japan [unintelligible] should be expanding faster and not doing something to contract. So, doing nothing is certainly agreeable to me.

CHAIRMAN VOLCKER. Well, we will have a lot to discuss in three weeks, I guess. Are there any other comments? If not, I will bid you adieu. No, adieu is too much. Au revoir.

MR. HELLER. Sayonara.

END OF SESSION